

RAILROAD VALUATION

AN ADDRESS

BY

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Mr. President and Gentlemen of the Associated Traffic Clubs: When Mr. Harkrader invited me to address this gathering on this occasion, I responded with a great deal of pleasure. Not, as I had indicated to Commissioner Lewis, that I was particularly keen to discuss this subject of valuation, a very vast and a very complex and a very difficult one; but it is always a pleasure to me to be in the presence of a Traffic Club or a group of Traffic Clubs. They amply illustrate, to my mind, the scriptural injunction that it is a good thing for brethren to dwell together in unity. Representing, as you do, shippers and railroads, you form a powerful factor for the welfare and ongoing of the industrial and transportation interests of the country.

A friend of mine recently remarked with respect to the subject of railroad valuation that it was about as clear as the Einstein theory and had about as much practical application. While I regard this as rather an extreme statement, it is nevertheless very true that it is a difficult and a many-sided and complex subject.

I hope, however, that in the time of yours which I shall take up in discussing the subject I will not qualify under the description given by the late Representative Reed, former Speaker of the House of Representatives, of a certain distinguished statesman from Tennessee. Some one asked him if he knew this man. (I will call him Smith, because that isn't his name.) "Know Smith? Why, certainly, I

have known Smith. I have known him thirty years, and he never opens his mouth that he doesn't subtract from the sum total of human intelligence."

I was advised by Mr. Harkrader that Mr. Commissioner Lewis would discuss this subject, but rather from an historical standpoint, and would not undertake to discuss any of the controversial aspects of valuation. We can all understand how that might readily be the case, occupying the position he does. However, I told Mr. Harkrader that if I was expected to discuss this subject of valuation and leave out the controversial aspects, it would be very much like the play of Hamlet with Hamlet left out. I didn't see how I could very well accomplish that, particularly as Mr. Commissioner Lewis would cover the only other aspects of it that would be of any particular interest to you.

So I want to say at the outset, gentlemen, that while I may seem to take sharp issue at times with some of the theories which have been expounded by the Commission on the subject of valuation, I want it understood that I do so in the fullest respect for the Commission and with a lively appreciation of the great ability and energy and zeal which it has displayed from the beginning in the discharge of perhaps the most onerous duties that are devolved on any public body in this country today, not excepting even the Supreme Court of the United States.

Mr. Commissioner Lewis has referred to the fact that Mr. Palmer used to be his boss. Mr. Commis-

sioner Lewis is one of my bosses; because, you know, the Interstate Commerce Commission is the big boss of all the railroads. But I suppose it is all right on certain occasions and under certain circumstances for a man to "sass" his boss a little.

As Mr. Commissioner Lewis has indicated to you, the subject of railroad valuation became of general interest with the passage of the Valuation Act of 1913, which appears as Section 19a of the Interstate Commerce Act. I want to say, however, before going further with the subject, that the valuation of a railroad is a very different thing from the valuation of an article of commerce. Railroads are not articles of commerce.

We know pretty well, by precedent, that there is a market for hogs and sheep and cattle and horses, and even very fine horses and very fine members of those various animal species. We know pretty well the market value of wheat and corn and oats and other articles of commerce. But railroads are not articles of commerce. They are not sold and exchanged on the markets. Rarely is a railroad sold, and then only when it is bankrupt and it is going through the process of receivership, or something of that kind. So there is no such thing as the market value of a railroad.

Therefore, it becomes necessary to establish certain principles to be observed in arriving at their reasonable value. I think the most generally accepted definition of value is the price which an article will

bring at a sale where the seller is a willing one and sells not under compulsion and the buyer a willing buyer not under compulsion. But those conditions don't obtain with railroads.

When the late Senator LaFollette introduced and finally secured the passage of the Valuation Act of 1913, as has been indicated by Commissioner Lewis (perhaps, not as forcibly as I shall put it), the basic claim that was made by Senator LaFollette was that the railroads of this country were tremendously over-capitalized and that if their true value was found it would develop that his claim was correct, that by squeezing out this water hundreds of millions of dollars a year would be saved to the shipping public of these United States.

He predicted that the process of valuation would occupy only a few years and cost a few millions of dollars. The process has been going on for sixteen years. There has been no finally established valuation of any important railroad system of the country, even though this process has been going on for that period, at an expenditure up to last June to the government of some \$34,500,000 and to the railroads of the country of some \$118,000,000, or a healthy total of \$152,500,000.

The outstanding fact which has been established by the valuation work is that the claims to over-capitalization of the railroads as a whole are without foundation. Therefore, while it seems a physical impossibility to keep valuations up to date in accord-

ance with the methods prescribed in the Valuation Act, yet, for the reason just stated, the making of the primary valuation, though not yet completed, has served a most useful purpose to the Government, to the railroads and to the general public.

I think it is well for us to consider just what are the provisions of this section 19a, under which the original valuation of the railroads was undertaken. It will lend clarity to our discussion of the subject.

It was provided, "First: In such investigation said Commission shall ascertain and report in detail as to each piece of property, other than land, owned or used by said common carrier for its purposes as a common carrier" what? "the original cost to date, the cost of reproduction new, the cost of reproduction less depreciation, and an analysis of the methods by which these several costs are obtained, and the reason for their differences, if any. The Commission shall in like manner ascertain and report separately other values, and elements of value, if any, of the property of such common carrier, and an analysis of the methods of valuation employed, and of the reason for any differences between any such value and each of the foregoing cost values."

I wish to call attention to the fact in this connection that in each of the tentative and so-called final valuations, although these final valuations have not been established, as I have previously said, the Commission has denominated them as "value for rate-making purposes." There is no suggestion in the

Act of any value for rate-making purposes or any other purpose. But, following the law of the land as laid down in the case of *Smyth v. Ames*, to which Mr. Lewis called your attention, Congress specified in this act the things that are to be considered and directed the Commission, after considering all those things, to report value. And I have always been one of those that believed that value means value—value not for this, that or the other purpose, but value—what the thing is worth.

I submit, also, that in making these reports the Commission has not carried out the injunction of Congress to report separately all the various elements of value referred to but has confined largely its findings of value to the cost of the physical reproduction of the properties as inventoried. There are numerous other elements of value, recognition of which, up to this time, we of the railroads have made no progress in securing at the hands of the Commission. I will refer a little later to the difference in value which may exist between railroads having substantially the same physical characteristics.

Now, as I have said, the principles required by the Transportation Act of 1920 to be employed in valuation were a clear recognition of the law of the land—the law of the land as was laid down in the case of *Smyth v. Ames* and numerous other decisions. But valuation assumed its present importance on account of the provisions of this statute, now known

as Section 15a of the Interstate Commerce Act, to which the Commissioner has just referred.

That provision, in brief, required that the Interstate Commerce Commission in fixing what shall constitute just and reasonable rates shall fix them as nearly as may be so as to yield a fair return on the value of the property devoted to the public service of the railroads as a whole, or in such groups as the Commission might see fit to divide them.

The provisions of Section 15a bearing on this subject (that is to say, the method of valuation to be employed) are as follows:

“For the purposes of this section, such aggregate value of the property of the carriers shall be determined by the Commission from time to time and as often as may be necessary. The Commission may utilize the results of its investigation under section 19a of this Act (that is the previous Valuation Act), in so far as deemed by it available, and shall give due consideration to all the elements of value recognized by the law of the land for rate-making purposes, and shall give to the property investment account of the carriers only that consideration which under such law it is entitled to in establishing values for rate-making purposes.”

The law of the land as laid down in the *Smyth v. Ames* case, I have already referred to. But I think it will be well enough to read an abstract from *Smyth v. Ames*:

“We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legis-

lative sanction must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth."

There is another important decision in one of the leading cases, that of the Indianapolis Water Company, in which the Court said:

"It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase. The decision of this Court in *Smyth v. Ames*, 169 U. S. 466, 547, declares that to ascertain value 'the present as compared with the original cost of construction' are, among other things, matters for consideration. But this does not mean that the original cost or the present cost or some figure arbitrarily chosen between these two is to be taken as the measure. The weight to be given to such cost figures and other items or classes of evidence is to be determined in the light of the facts of the case in hand. By far the greater part of the company's land and plant was acquired and con-

structed long before the war. The present value of the land is much greater than it cost; and the present cost of construction of those parts of the plant is much more than their reasonable original cost. In fact, prices and values have so changed that the amount paid for land in the early years of the enterprise and the cost of plant elements constructed prior to the great rise of prices due to the war do not constitute any real indication of their value at the present time."

I think, generally speaking, the railroads are in a very similar situation to that in which the Court found the Indianapolis Water Company to be.

But the Commission, in undertaking this tremendous and almost overwhelming task of valuation, has applied to the structural elements found on the date of valuation the prices current in the year 1914. Of course, we have gone through an entire change in the whole aspect of costs of construction since that time. And I submit that, even if we grant that the cost of reproduction alone of a railroad is the sole standard of measurement to be applied (which I do not admit), certainly a cost of reproduction made on the basis of prices in 1914 is obsolete sixteen years thereafter.

There are a whole lot of things beside the cost of reproduction that enter into the value of a railroad. Take two lines of railroad between the same points, if you please; both having identical physical characteristics; both costing, at current levels of prices, the same to reproduce. One is seventy-five years old, with an efficient organization, a patronage, an *esprit*

de corps, a long history of successful operation. And the other one was built and completed last night, without any of these things. Which of those two railroads would you say was worth the more?

You give me enough money, and I can reproduce the Pennsylvania Railroad on top of the Rocky Mountains. What would it be worth on top of the Rocky Mountains? Certainly, it wouldn't be worth its cost of reproduction.

Those are examples tending to establish the proposition that I have in mind, that there are various elements of value besides the mere physical cost of reproducing the properties.

The much-discussed O'Fallon case presented the first opportunity to test the validity of the methods employed by the Commission in valuing the railroads. The Supreme Court condemned those methods for failure to follow the law of the land as required by statute. I wish to quote an extract from the Supreme Court's opinion. I think I have it here. This is what the Supreme Court said:

"In the exercise of its proper function this Court has declared the law of the land concerning valuations for rate-making purposes. The Commission disregarded the approved rule and has thereby failed to discharge the definite duty imposed by Congress. Unfortunately, proper heed was denied the timely admonition of the minority—'the function of this Commission is not to act as an arbiter in economics, but as an agency of Congress, to apply the law of the land to facts developed of record in matters committed by Congress to our jurisdiction.' "

But, shortly after the announcement of the O'Fallon decision, with the obvious purpose of entirely circumventing by legislative enactment, if possible, the effect of that decision, Senator Howell introduced a resolution into the Congress of the United States which, in effect, undertook to direct the Interstate Commerce Commission, in valuing railroad properties, to apply the principles applied by them in valuing the O'Fallon Railroad.

Soon after the introduction of this resolution, I think, the Chairman of the Senate Committee on Interstate Commerce, Senator Couzens, wrote a letter to the Commission with respect to this matter and invited its criticism of this resolution.

In a very able, exhaustive and discriminating discussion of the whole subject, Mr. Commissioner Eastman, the Chairman of the Legislative Committee of the Interstate Commerce Commission, replied to Senator Couzens' letter. He pointed out that, if what was in view in this resolution was to be considered by Congress, it perhaps would be better that the legislation take the form of a positive amendment to the terms of the Interstate Commerce Act, including the provisions of Section 15a, rather than a mere resolution, directing the Commission to use certain methods, since a mere direction of that kind would still leave the Commission open to the claim that it was not following the mandate of Congress as laid down in express terms in Section 15a.

As a result of this correspondence, a bill has been introduced by Senator Howell which conforms, with some exceptions, to substantially the recommendations of Commissioner Eastman and undertakes a complete change in the basis of Congress' direction to the Commission with respect to the subject of the methods to be employed in valuing the railroad properties of this country.

If the proponents of the Howell Bill intend the amount ascertained by the method therein prescribed shall be the value of railroad property, in my judgment they lose sight of a fundamental distinction—that valuation is a judicial and not a legislative process. I do not believe that Congress is competent—that is to say, that it is within the constitutional right of Congress—to fix by any rule what the value shall be. That is a judicial question.

Every railroad in this country has the inherent right to have its property valued in the light of the peculiar circumstances surrounding that property; and it is a right which cannot be taken away from it by Congress, however desirable it may be to set up some sort of a universal yard-stick or measuring device by which all the railroads may be passed through a common hopper and come out completely valued.

What I mean to say is this: Everybody recognizes the tremendous difficulty and the almost insurmountable labor involved in the Commission undertaking to value each railroad separately in the way I

have suggested. But, difficulty in administering the law cannot be taken as an excuse for doing violence to the constitutional rights of a railroad to have its property valued by a judicial process.

If the Howell Bill be interpreted as I have suggested, it is open to that very serious objection. In other words, if this legislation purports to develop a new basis for determining value, it is not in accord with the law of the land as laid down by the Supreme Court of the United States.

To be sure, throughout this bill, it doesn't use the word "value." It uses the words "rate base." But, "rate base" is not "value." A finding of value is one thing. A conventional finding of a rate base is quite another thing. But no court would accept a rate base found under the terms of this legislation, in my humble opinion, as a satisfaction of a railroad's right to a valuation of its property.

As a practical proposition, if the Howell Bill merely proposes the use of a conventional or arbitrary rate base, as a mere part of a plan for rate-making, having for its underlying purpose, as the national policy, that rates shall be adequate to enable the carriers to meet the transportation needs of the country, I do not believe such proposal would be particularly objectionable; and I say this even though in making the rate base it adopts, with some variations, the principles which the Commission has applied in the valuation of the railroads of the country, and which were condemned by the Supreme Court in

the O'Fallon case. This bill, as I have shown, has some other very objectionable features; but if these could be satisfactorily disposed of, that provision calling for an arbitrary rate base which would produce an adequate rate level should, I think, be acceptable to the railroads.

In it I find, personally, a good deal to commend itself to me. I think there is much in what Commissioner Eastman said in his letter to the Chairman of the Senate Committee on Interstate Commerce as to the desirability of stabilizing the valuation of these railroads, particularly so far as it relates to this matter of rate-making. But I submit, as I said before, that a rate base is one thing. It may be an entirely acceptable thing for rate-making purposes. It is quite another thing if a question of confiscation arises, or if the Government attempts to use the amount so ascertained in a recapture proceeding. And when either of those conditions arises, the railroad whose treasury it is proposed to invade is entitled to the constitutional protection of the value of its property, the true value—not an arbitrary rate base, or a conventional method of arriving at what value shall be used for rate-making purposes. These are two entirely separate and distinct things.

There is one provision retained in this Howell Bill which in my opinion is really the seat of most of the difficulties at the moment surrounding valuation, and that is the retention of the so-called recapture clause.

Section 15a of the Interstate Commerce Act not only provides the basis for making rates, which I have already described, requiring the Commission to fix what shall constitute a reasonable return on these groups of railroads; but it also provides that, with respect to any individual railroad, if its earnings during any one year exceed six per cent, then one-half of those excess earnings shall be paid into the treasury of the United States, to be used for certain specified purposes, particularly loans to weak railroads.

That has been of no practical consequence, because the Commission very properly has exacted as a condition to those loans that the loans shall be good; and, if the loans are good, they don't need to be obtained from the United States Government, because they can be gotten from a banker.

The Government is very much like a banker in Louisville, a very dear friend of mine, who has since passed to his reward, about whom another very dear friend said, "Anybody that can borrow money from that man don't need it."

That principle of the recapture is retained in this proposed legislation of Senator Howell's; but, connected with, to my mind, a very vicious provision. And I say that with all due respect to Senator Howell and anybody else that is favoring any such legislative program. It provides that that portion of the funds recapturable from the railroads which is payable to the United States Government, instead of being paid to the Government for such uses as it may prescribe,

shall be invested by the railroads in so-called non-productive railroad property, upon which the railroads shall not be permitted to earn any return whatever beyond four per cent, which shall be paid to the United States Government.

Now I submit that that is introducing the principle of government ownership in the railroads with a vengeance. Railroads would be required, under that provision, to issue certificates, trustee certificates, of an interest of the United States Government in their properties. And the calculation has been made with respect to a certain railroad that I won't mention that, in the course of fifty years, forty-nine per cent of the property of that railroad would be in effect owned by the United States Government.

I say that that will not meet, in my judgment, the approval of the overwhelming majority of American citizens, who are committed to the American ideal of private ownership and initiative in the conduct of the business enterprises of this country; and while it may be favored by a few advocates of government ownership in and out of public office, it will meet the condemnation of the balance of our citizenship.

I think the recapture clause has few friends inside or outside of the Government. It has been of no practical importance up to this time. There is some money, I believe, Mr. Commissioner, at the Commission's disposal as a revolving fund in this matter. But the amount is limited. There has been no particular use made of it. It is lying there. Substan-

tially few, if any, important railroads have admitted as yet that their values are so related to their earnings that any part of them are recapturable under this provision. In other words, they don't admit that they have been earning more than six per cent on their value. And to establish that will require endless litigation and will involve this very question of fundamental, true value, which the Commission and Congress itself apparently are trying to escape.

The repeal of the recapture clause would, I believe, open the way for a sensible and statesmanlike solution of all of these difficulties; because, after all is said and done, these questions are in the main, and until you get into some actual litigation, academic. Yet notwithstanding our talk about the law of the land and the constitutional rights of the railroads, we know, as a matter of fact, that under its own tentative valuation, the Commission has not as yet prescribed rates which during any single year have returned the five and three-quarters per cent fair return contemplated in Section 15a. In no year have the railroads of this country earned that fair return.

Well, now, it mustn't be assumed, because that is the case, that the Interstate Commerce Commission has fallen down in its duty to the carriers in protecting their rights. But the truth of the matter is that, regardless of the emphasis laid on valuation and the fact that a return on value is made the yardstick by which the reasonableness of any given set of rates shall be judged, the value of a railroad prop-

erty is only one of the elements, and a fair return on that value is only one of the elements, controlling the fixing of rates.

There are numerous other elements that are beyond the control of the railroads, the Interstate Commerce Commission or the Government itself. They are inexorable economic laws—the competition of section with section, of industry with industry, and of different parts of the same industry with each other. Then there is the competition, sad to relate, of other forms of transportation—subsidized forms of transportation. These are the Government barges plying our waterways, into which the Government is pouring millions of dollars without charging any interest thereon in the cost of operation; also the busses and trucks that are used on public roads built and maintained with the taxes of the people, to which the railroads are no inconsiderable contributors, and which in the main are allowed to be used for common carrier purposes without the owners of these motor lines paying an adequate compensation for such use or otherwise sufficiently participating in the cost of their construction and maintenance.

So there are a lot of factors that enter into the determination of a rate beside the mere value of the property of the railroads; and these considerations are largely economic and beyond the control of any regulatory body.

Take the case of a railroad running from A to B, which the Commission finds is reasonably worth

\$25,000,000. But, there is a highway paralleling it, which has been subsidized largely for common carrier purposes; and they put in busses and trucks, etc., to haul freight and passengers between those points. It wouldn't make any difference whether that railroad was valued at \$25,000,000 or \$50,000,000 or any other sum. What influence would its valuation have on the rates which it may find necessary to charge to participate in this competitive traffic?

I am not meaning to say that railroads are not entitled to earn a fair return on their value. On the other hand, I stoutly assert that this has been the common law always and the rate-making provision in Section 15a was merely translating into statutory form what had been the common-law right of railroads all the time. It is the right of every railroad, if it can do it, to earn a fair return on the value of its property. And I don't think the public can be heard to complain if its earnings are limited to a fair value on the property devoted to the public service.

Certainly, the Commission has been most conservative in fixing five and three-quarters per cent, when telephone companies and water companies and gas companies and other utilities, by a judicial determination, are allowed to earn up to seven and eight per cent on the value of their properties.

There has been a great deal of overemphasis laid on the relationship, anyhow, between valuation and the rates. The notion, I think, is pretty generally entertained by people who have not taken the trouble

to inform themselves that any large increase in the valuation of railroads will produce a corresponding increase in rates; for example, that if the railroads were valued at fifty per cent more than any given basis which might be proposed, that would at once imply an increase in rates of fifty per cent.

Of course, that is absurd if you will think of it for a moment, because when we deal with railroad revenues we are dealing, generally speaking, with only about twenty per cent of the gross revenues, since the operating ratio of the average American railroad is about eighty per cent. So that if this process of transportation was conducted by the railroads without any return to them on their properties whatever and at a mere charge sufficient to cover the cost of operation, the shipping public would still have to pay eighty per cent of the present rates. And this would be equivalent to the railroads, so far as their interest is concerned, giving the public the transportation.

So that an increase in a given value of fifty per cent, assuming that the present return was reasonable on the lower valuation, would not imply an increase in rates of fifty per cent, but an increase of fifty per cent of twenty per cent, which would be ten per cent. And, by the same token, an increase in the earnings of railroads of twenty per cent would involve an increase in rates of only four per cent.

There is enough statesmanship, in my judgment, in this country, both among the railroads and in the

Interstate Commerce Commission and in the Congress of the United States—although some of you may take that last statement with a grain of salt—certainly there is enough in the American people as a whole, to solve this problem along reasonable and rational lines—lines which will do justice to the owners of these properties and will enable the maintenance of the American ideal of private ownership and operation of business enterprises as distinguished from the intrusion of the Government into those enterprises—to produce a reasonable and satisfactory solution of this whole question. And I look forward with confidence that this will be done.

Standing as it does today, I have no hesitation in predicting that the valuation of the railroads of this country will never be completed. I have no hesitation in saying that, if you could concede that it would be completed, it will be obsolete long before it is completed.

After all is said and done, gentlemen, the maintenance of adequate and efficient transportation is of paramount importance. It is of much greater importance than whether the rate shall be this, that or the other—provided always that the rate is not such as to return more than a fair earning on the value of the properties devoted to the public service.

Inefficient, inadequate transportation is dear at any price. Efficient and adequate transportation is cheap at almost any conceivable price.



